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SUBJECT: MONEY TALKS, BUT IS NORWAY LISTENING?

¶1. (U) Summary: On March 22 Norges Bank Governor General Svein Gjedrem presented diplomatic corps members with a vision of an incredibly vibrant, but oil-dependent, Norwegian economy reaching new fiscal heights on the wings of increasing energy demand and oil prices. Gjedrem's analysis of the economy included some criticisms and concerns, particularly regarding individual pension abuses. The speech tracked many of the OECD's observations in its January 2007 Survey on Norway, although Gjedrem glossed over glaring weaknesses in Norwegian innovation and entrepreneurship that the OECD report highlights. End summary.

Giddy with Globalism: Terms of Trade Turn in Norway's Favor

¶2. (U) Governor Gjedrem stated that Norway's oil-rich economy is experiencing strong growth, high-capacity utilization and low inflation. Gjedrem attributes this rosy picture to a series of favorable global developments and "positive supply-side shocks." Norway's capacity utilization is high in most industries, with rising unfilled vacancies and labor shortages across several sectors. Purely physical production constraints (such as shortages of rigs in the petroleum industry and construction industry machinery) appear the only factors constraining the utilization.

¶3. (U) Unemployment has declined, with the unemployment rate hovering slightly over 2 percent. Temporary foreign labor supplies increased markedly after the EU's enlargement in 2004, with labor inflows amounting to more than 30 percent of growth in Norway's labor force.

¶4. (U) Recent trends in the terms of trade have benefited Norway tremendously. Global growth has spurred a vibrant upswing in Norwegian export industries, most notably Norwegian petroleum exports. Strong demand growth, coupled with solid profitability, have also stimulated fixed investment. The increased integration of China, India and other emerging economies into global trade markets, in conjunction with lower tariffs and reduced trade barriers, has led to a significant decline in prices of imported finished goods. In Norway, imports from low-cost countries have significantly increased. Gjedrem noted sharp price declines for Norwegian consumers in a wide-range of consumer

goods, from footwear to audiovisual equipment. The increase in developing market acquisitions has led to a substantial decrease in U.S., Japanese and EU (excluding "new" EU members) consumer imports. The confluence of higher Norwegian export prices and lower import prices for most consumer goods created a remarkable favorable shift in Norway's terms of trade, which improved by approximately 40 percent since 2002.

15. (U) Domestically-produced goods and services have decreased in price, which Gjerdem attributes to increased competition. In a recent Bank survey, 58 percent of the responding companies noted intensification of competition in the last 2-3 years, with only 15 percent finding a competition decrease. In retail trade and services, 70 percent of sector respondents noted increased competition.

16. (U) In the Norwegian business sector, increasing integration of information technology and productivity gains in banks and financial service sectors also contributed to the overall Norwegian economy's growth.

Monetary Policy: What Next?

17. (U) The Bank utilizes a flexible inflation targeting regime as part of a monetary policy oriented towards low and stable inflation (annual consumer price inflation stands at about 2.5 percent). Consumer price inflation is expected to increase, however, due in part to capacity constraints that limit future growth, falling unemployment, gradual upticks in wages, and marked price increases for inputs, services and building materials. Acknowledging these concerns, the Bank will continue to raise interest rates, while watching the impact of higher interest rates on the Norwegian kroner exchange rate when inflation is low. The Bank's Executive Board decided on March 15 to pursue a course designed to level the key policy rate at between 4-5 percent, rising to approximately 5 per cent by the end of 2007, depending on economic conditions.

A Person's Home Really Is A Castle

18. (U) Housing costs have trebled over the last 14 years as more people migrate to densely populated areas. Consumer demands for high standards, coupled with new building regulations, push up housing construction costs and thus housing prices. Declaring that the housing market is in a state of "euphoria," Gjerdem noted that the historical determinants of housing price inflation have been income, unemployment, interest rates and residential construction. These have recently coupled with migration to urban areas and consumer expectations that housing prices will continue to rise, inducing younger buyers to enter the housing market earlier for investment purposes. Rising housing prices have increased household debt, now twice the level of disposable income, with debt to income ratios at the highest levels ever seen in Norway.

The (Multi) Billion-Dollar Question: The Pension Fund's Strategy

19. (U) Currently worth about \$293 billion, the Norwegian Pension Fund continues to increase on the strength of high energy prices. Gjerdem emphasized that Norway does not view petroleum revenues as income, but rather as a transfer of capital from petroleum extraction to diversified foreign securities. Gjerdem shrugged off critics who call for spending Pension Fund revenues on social needs, noting that the Fund's cash flow has swung widely in the past and spending it would cause significant fluctuations in domestic demand. Currently, the Fund is approaching the nominal value of one year's GDP, and may reach two in the next decade. The GON spends about 4 percent of the Fund's revenues annually to cover budget shortfalls based on the theory that the Fund's average real return is an equivalent percentage. Gjerdem

thought the percentage could rise as high as 15 percent of government expenditures in 10 years.

Not All is Happy in Mudville

¶10. (U) Fielding questions from the diplomatic audience, Gjedrem shared insights on the dilemmas facing emerging oil economies, challenges to the Fund and societal issues that could affect Norway's robust economy. Addressing the Nigerian economic counselor, Gjedrem advised emerging oil countries to balance increased oil production capacities with infrastructure investments. Gradual improvements in infrastructure would lead to increased production capacity. With respect to investment strategies, he stressed that emerging economies should follow the prudent strategy of diversifying wealth in international markets.

¶11. (U) Gjedrem outlined challenges that could face the Pension Fund -- an unexpected sharp decrease in oil prices or an "overheated" Norwegian economy, harbingers of which could include wage inflation and a housing market bubble. While reiterating the Pension Fund's strategy to diversify between equity investments and bonds, he stressed that Fund proceeds should be spread out in several portfolios. Gjedrem strongly supported the Norwegian Fund's policy to invest 100% of its proceeds abroad. He emphasized that Norwegians simply do not want to subsidize capital, since domestic Fund investments (such as those in government projects) would eventually mean lower returns. Questioned whether the GON's use of 4 percent of Fund proceeds for government spending is adequate, the Governor answered in the affirmative, noting that government revenues were projected to increase by 15 billion NOK (about USD 2.5 billion) in 2007. He added that for every one billion NOK spent by the GON, the Bank would tighten its monetary policy constraints.

¶12. (SBU) Gjedrem was blunt regarding early retirement and disability drains on the Fund. He noted that although the official retirement age in Norway is 67 years old, the average real retirement age is 60. He revealed that the government is considering increased benefit incentives to keep workers in the labor force until age 70. He thought it necessary to reduce incentives for early retirement and cited as worrisome the growing number of disability claimants in their thirties and forties (approximately 7 percent of the workers available in that age bracket). Acknowledging his thoughts controversial for a public official, he advocated greater businesses contributions to pension financing and decreased benefits to disability claimants.

OECD Survey: Some Warning Signs, and Government Response

¶13. (U) The Organization for Economic Cooperation and Development (OECD)'s Survey mirrors several of Gjedrem's themes. The Survey describes a booming economy, with low unemployment and moderate underlying inflation. The influence of globalization on the economy's continued vibrancy (namely supplying high-priced exports like petroleum while importing lower-cost consumer goods) was highlighted. Inflationary controls and the Bank's decision to edge up interest rates were also discussed. The Survey shared Gjedrem's concerns that the effective retirement age is on a downward trend, despite the high statutory age. The Survey warns that the Pension Fund may not be sustainable if the trend continues, particularly as social benefit "schemes" (sickness and disability benefits and early retirement) tend to undercut incentives to remain in the work force. The Survey warns that "Norway must resist the temptation of finding in higher-than-expected oil revenues an excuse for delaying the adoption of necessary reforms."

¶14. (U) Innovation is also a real concern. The Survey critiques Norwegian technology-driven innovation, stating it is low by cross-country indicators. The OECD points to weak research and development intensity, only moderate patenting and a limited interest in innovation activity. Encouraging

product-market innovation was one OECD proposal. The OECD credits the GON for its desire to promote innovation, but questions whether government spending plans can accomplish the objective. For example, while crediting as well-designed Norway's plans to increase innovation through research grants and tax credits, the Survey questions whether additional fiscal support would be very effective given the private sector's reluctance to spend much on innovation.

¶15. (U) To promote entrepreneurship, the Survey proposes strengthening competition policy and relaxing product market regulations, while reducing state ownership in the economy. Additional public money will not, in itself, foster a greater innovation culture. The OECD recommends private-public research and facilitating commercialization of university innovations. Finally, the OECD recommends allocating more public funds to institutions that channel venture capital funds to private start-ups.

¶16. (U) The Norwegian Ministry of Finance issued a statement calling the Survey's analysis of the Norwegian economy "comprehensive." Finance Minister Kristen Halvorsen said the document should "stimulate the debate on important economic policy issues," but brushed aside the OECD's call for more innovation by declaring that Norwegian firms' abilities are no worse than companies in other developed countries.

The IMF: More Mounting Concerns

¶17. (U) On March 26, the International Monetary Fund (IMF) issued a report warning that the Norwegian economy is confronting growing inflationary pressures, citing continuing credit growth and housing price increases. The report suggested that the GON confront rising inflation by raising interest rates. In addition, the IMF report recommends that the GON refrain from spending the entire 4 percent of the Fund's revenues annually, given that petroleum prices are much higher today than when the guidelines suggesting this dedicated percentage were instituted.

Comment: Lots of Money, Lots of Oil: What, Me Worry?

¶18. (SBU) An economy largely dependent on vast petroleum riches, coupled with a strong social welfare system, would in most countries be a recipe for disaster when the oil pumps run dry. Norges Bank believes that a policy of fiscal austerity, with a commitment to diversifying Pension Fund riches, could generate sufficient income to put the day of reckoning off indefinitely. Governor Gjedrem voiced the word "diversification" over a dozen times in his speech. In recent months, the Bank has recommended spreading some of its moneys (USD 75 billion for starters) into international commercial real estate and private equity/venture capital markets. If approved by the Norwegian parliament, investments of that volume could begin to play a significant role in U.S. real estate and venture capital markets.

¶19. (SBU) But will buying more foreign assets keep Norway afloat in the long run? We concur with the OECD's assessment that innovation and entrepreneurship are areas of deep concern. Norway's over-reliance on petroleum revenues and Pension Fund money contribute to a cultural atmosphere of dependence reflected in a declining national work ethic. In European consumer preference surveys, for example, Norwegians rank taking a good annual vacation at the top of the list, well above finding interesting work or building a productive career. These and other cultural roadblocks, like the Scandinavian penchant for social leveling, discourage entrepreneurship. The dependency on oil largesse is contributing to lower productivity -- not in the statistical sense, in which Norway outranks many other developed countries, including the United States -- but in the sense that many basic skills and standards of service seem to be eroding. Norwegians are turning to a growing foreign workforce to do much of the heavy lifting. Even in the lead

petroleum sector, most of the infrastructure construction work in major investment projects is now performed by imported foreign workers. Norway seems to have bought into its own press -- seeing itself as a highly productive, innovative society -- but the very fact that the Norwegian government is compelled to invest significant public funds on innovation programs speaks volumes. The government, with its dominant role in the economy and as guarantor of the cradle-to-grave social welfare system, has so undercut individual initiative that the GON must institute a government program to re-stimulate it.

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